

Understanding Investor Behavior and Profiting From It

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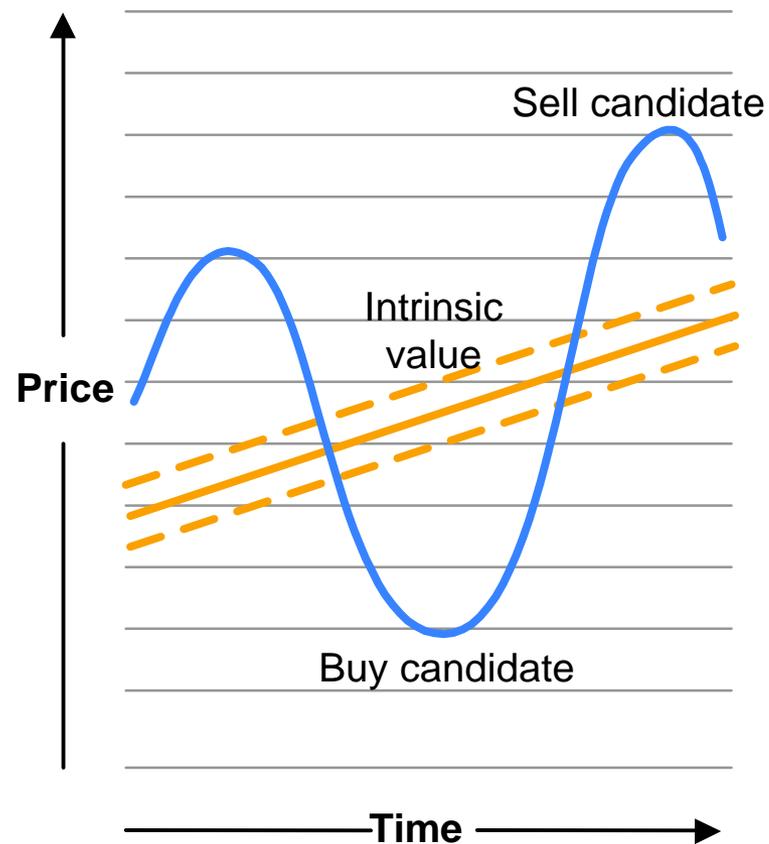
Beware of your own behavioral tendencies

- ◆ Prospect theory
- ◆ Mental accounting
- ◆ Fear of regret
- ◆ Anchoring
- ◆ Overestimating your ability
- ◆ Too much emphasis on recent events, using the wrong information

Overcoming behavioral bias

Stay objective

- ◆ Application of a consistent investment philosophy
- ◆ Focus on fundamentals
- ◆ Application of team skills and resources



Fundamentals tell the whole story

S&P 500: December 31, 1954—March 31, 2005

December 31, 1954 yield = $\$1.64/\35.98 = 4.56%

Actual growth in dividends = 5.23%

Share Repurchases = 0.50%

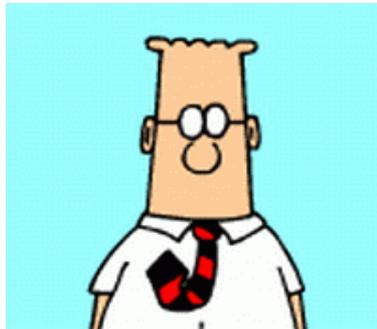
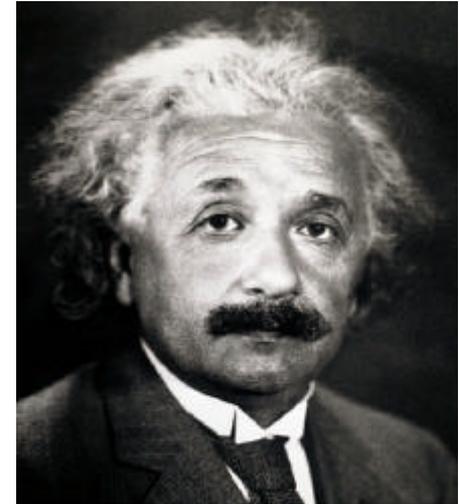
Implied return = 10.53%

Actual return = 10.84%

Beware of your own behavioral tendencies

“Only two things are infinite, the universe and human stupidity, and I'm not sure about the former.”

Albert Einstein



“Nothing defines humans better than their willingness to do irrational things in the pursuit of phenomenally unlikely payoffs”.

Scott Adams, creator, “Dilbert”

Make a choice

- ◆ A sure gain of \$3,200, or
- ◆ An 80% chance of \$4,000 and a 20% chance of getting nothing

Make a choice

- ◆ A sure loss of \$3,200, or
- ◆ An 80% chance of losing \$4,000 and a 20% chance of no loss

Loss aversion

People strongly prefer avoiding losses to making gains

- ◆ A sure gain of \$3,200
- ◆ An 80% chance of \$4,000 and a 20% chance of getting nothing

Most people take the sure gain of \$3,200

- ◆ A sure loss of \$3,200
- ◆ An 80% chance of losing \$4,000 and a 20% chance of no loss

Most people take a chance to avoid the loss

How to defeat your own behavioral tendencies

Prospect theory

- ◆ Calibrate your mental market model symmetrically
- ◆ Don't double down when you are behind



How to defeat your own behavioral tendencies

Mental accounting

- ◆ Don't compartmentalize your wallet
- ◆ Make investment decisions in light of your overall portfolio
- ◆ Don't play frivolously with "House Money" when you are ahead



How to defeat your own behavioral tendencies

Fear of regret and anchoring

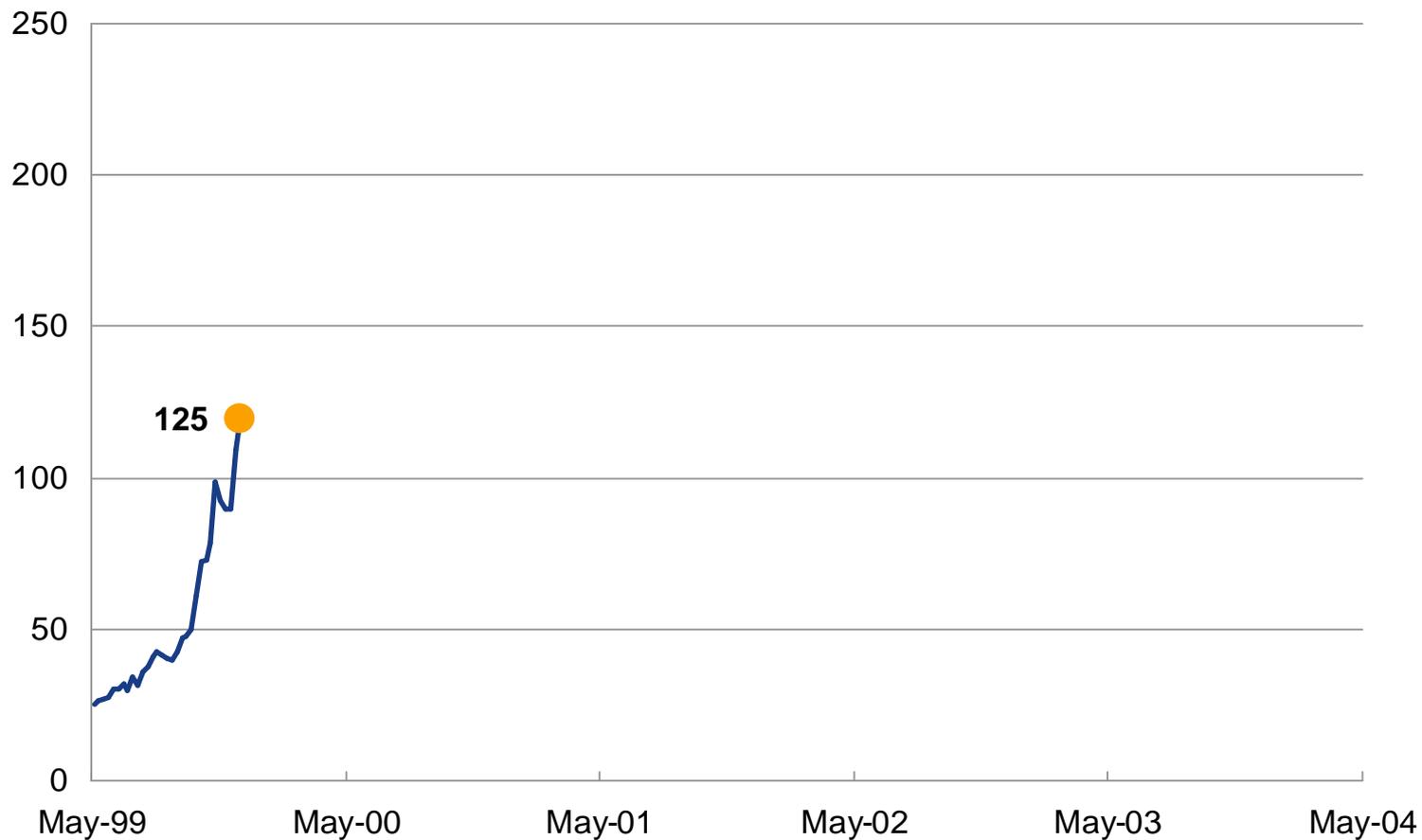
- ◆ Relevant and irrelevant anchors
 - Prime rate six months from now
 - Year of Attila the Hun's defeat in Europe?

In application.....

- ◆ Would you buy the stock today?
 - Have a thesis at time you buy the stock
 - Is the thesis intact?
- ◆ Build a new portfolio every day

How to defeat your own behavioral tendencies

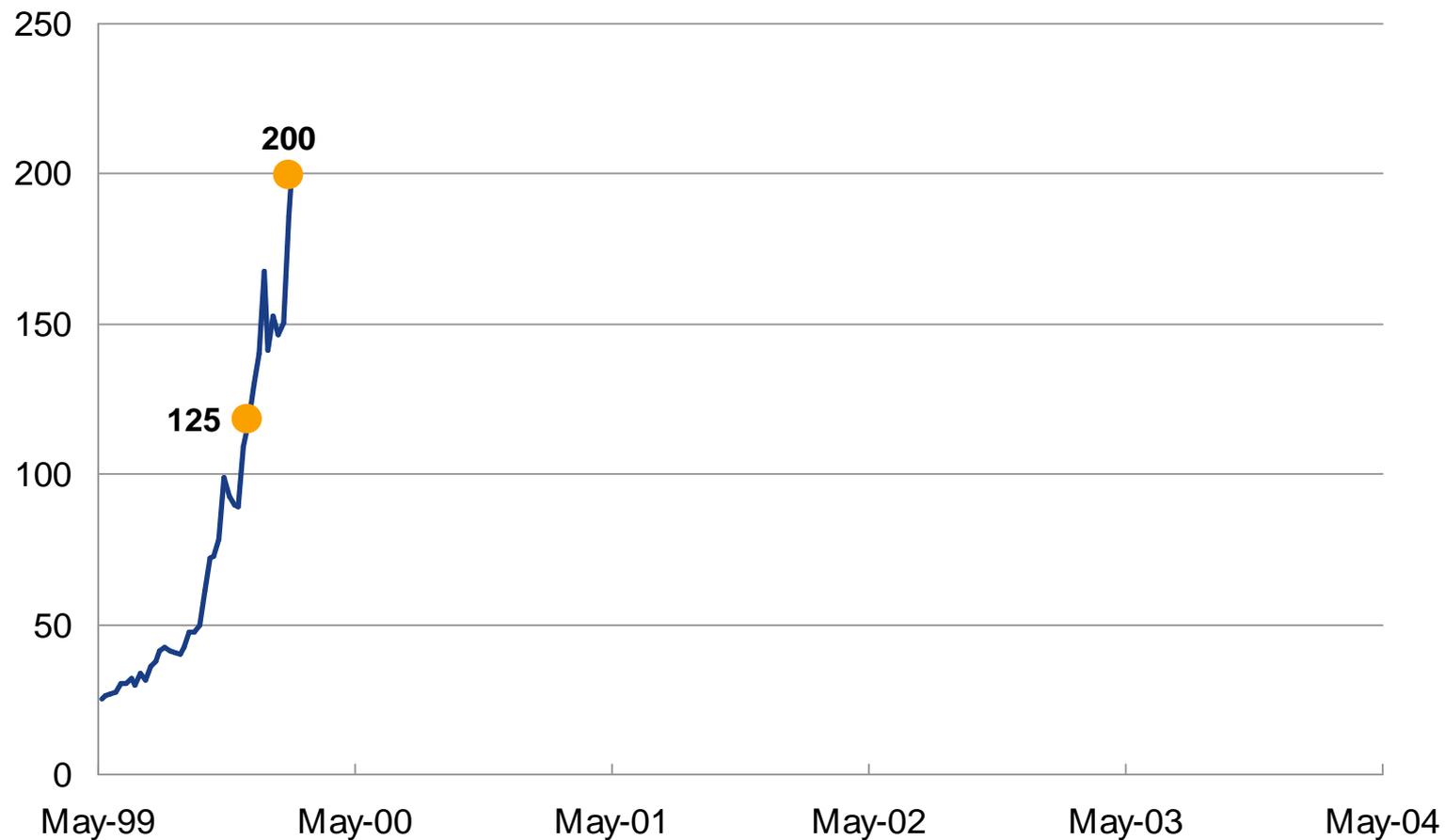
Fear of regret and anchoring



Source: Factset

How to defeat your own behavioral tendencies

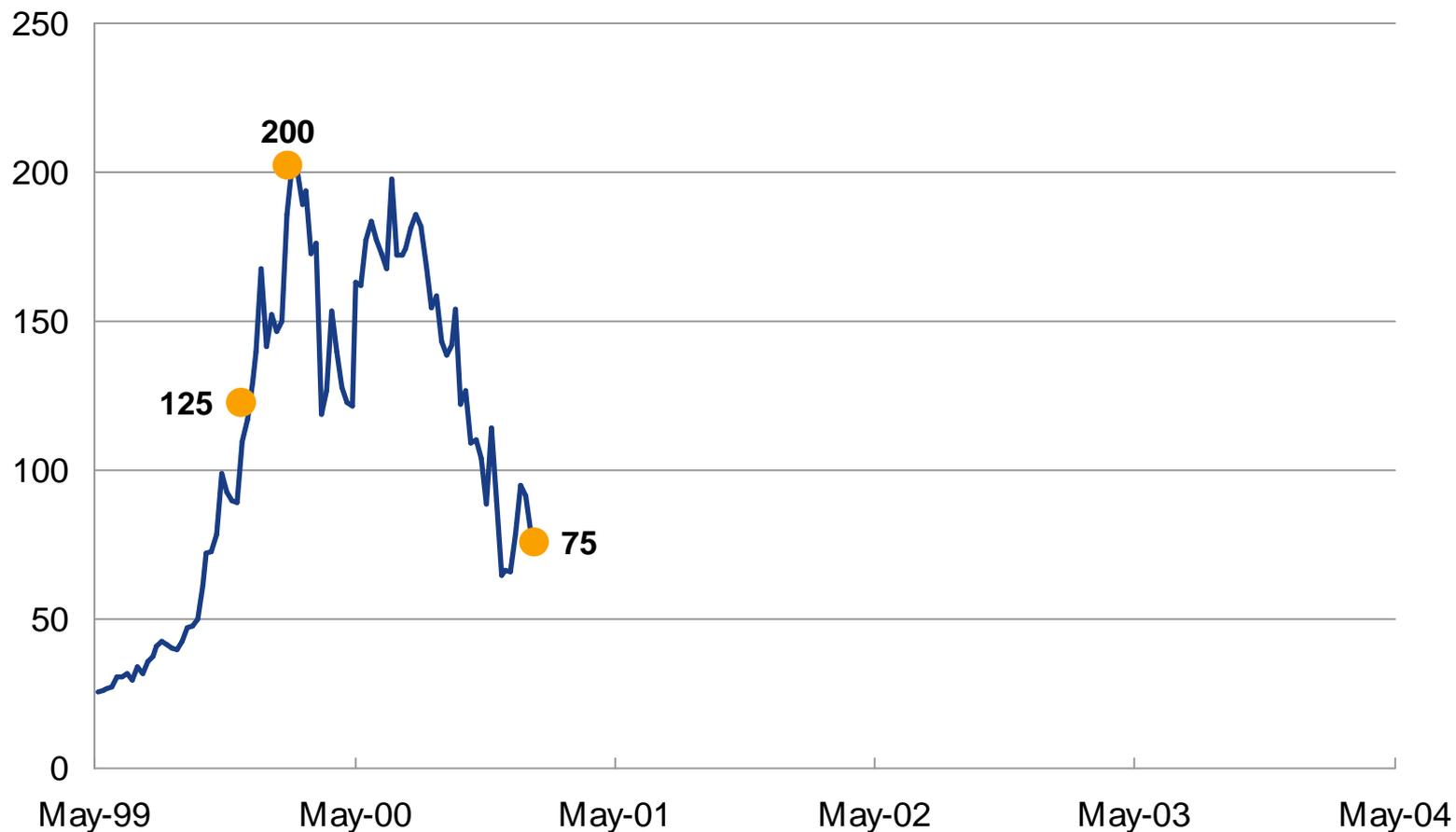
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Source: Factset

How to defeat your own behavioral tendencies

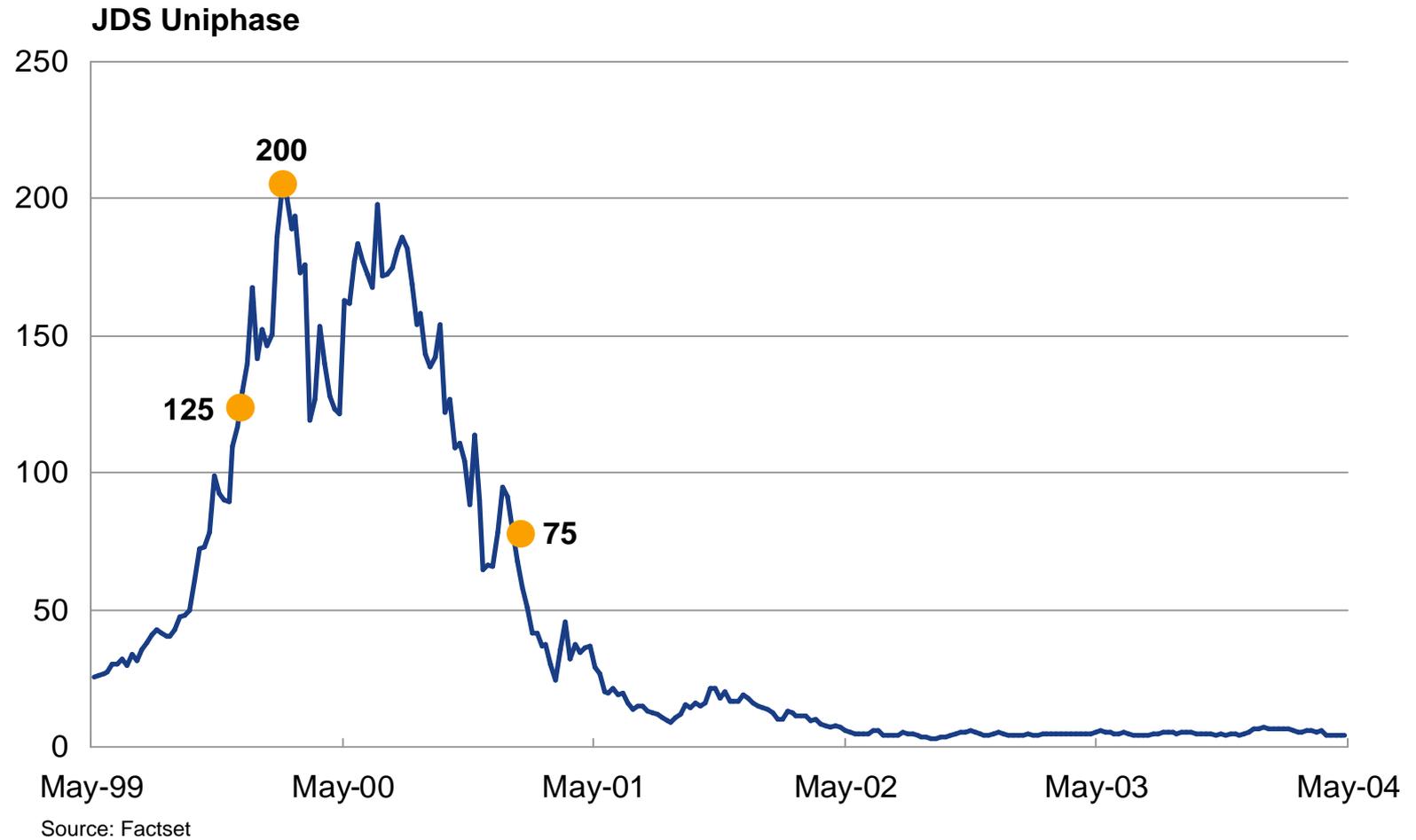
Fear of regret and anchoring



Source: Factset

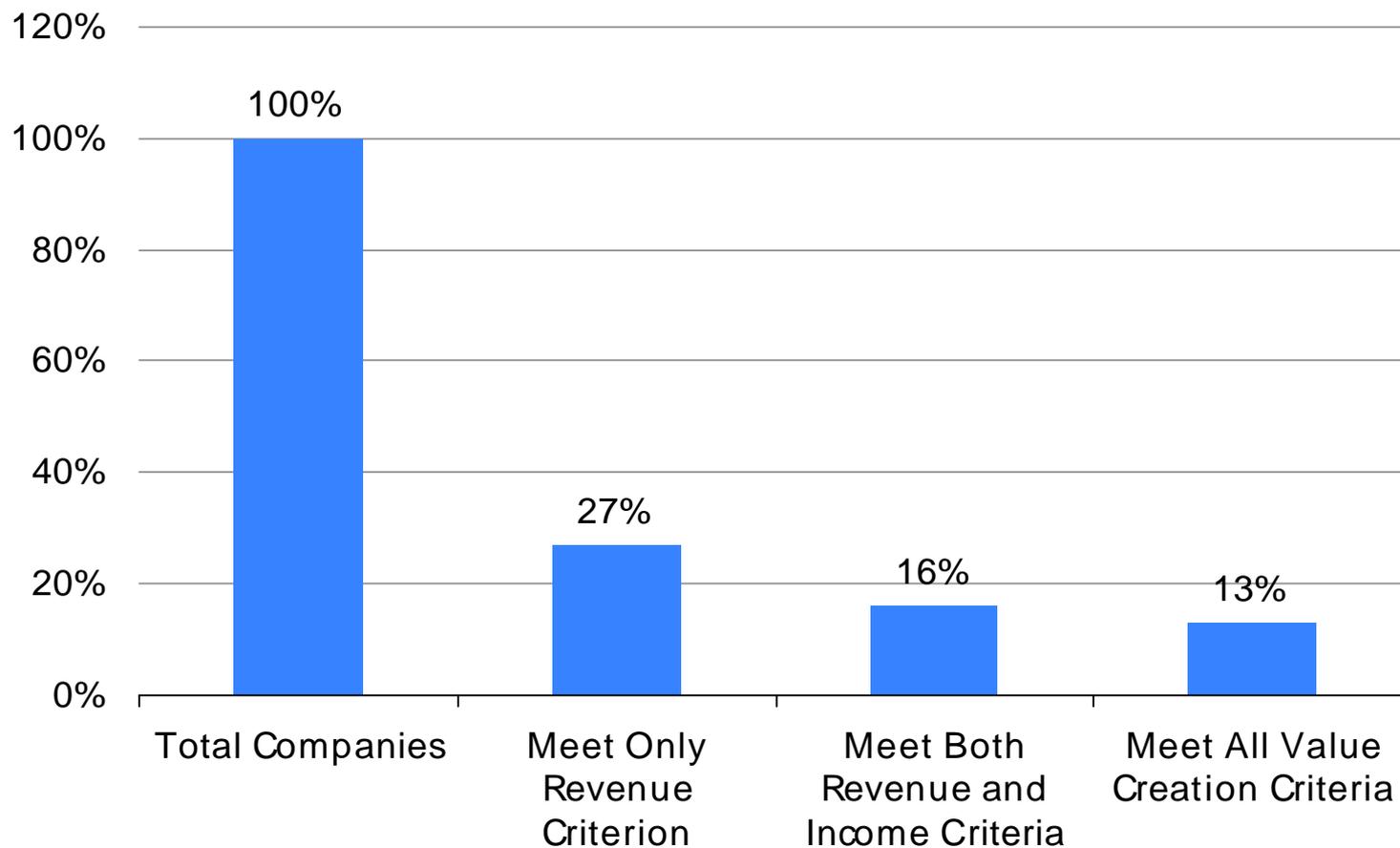
How to defeat your own behavioral tendencies

Fear of regret and anchoring



Reality of growth

Few companies achieve sustainable growth strategies



Source: "Profit From The Core" by Cris Zook, Worldscope, Bain Analysis

How to defeat your own behavioral tendencies

Overestimating your ability



How to defeat your own behavioral tendencies

Over estimating your ability

“Confidence is contagious. So is lack of confidence.”

-Vince Lombardi

Ten Questions	Low	High
1. Martin Luther King's age at death.		
2. Length of the Nile River.		
3. Number of countries that are members of OPEC.		
4. Number of books in the Old Testament.		
5. Diameter of the moon in miles.		
6. Weight of an empty Boeing 747 in pounds.		
7. Year in which Wolfgang Amadeus Mozart was born.		
8. Gestation period (in days) of an Asian elephant.		
9. Air distance from London to Tokyo.		
10. Deepest (known) point in the oceans (in feet).		

How to defeat your own behavioral tendencies

Too much emphasis on recent events

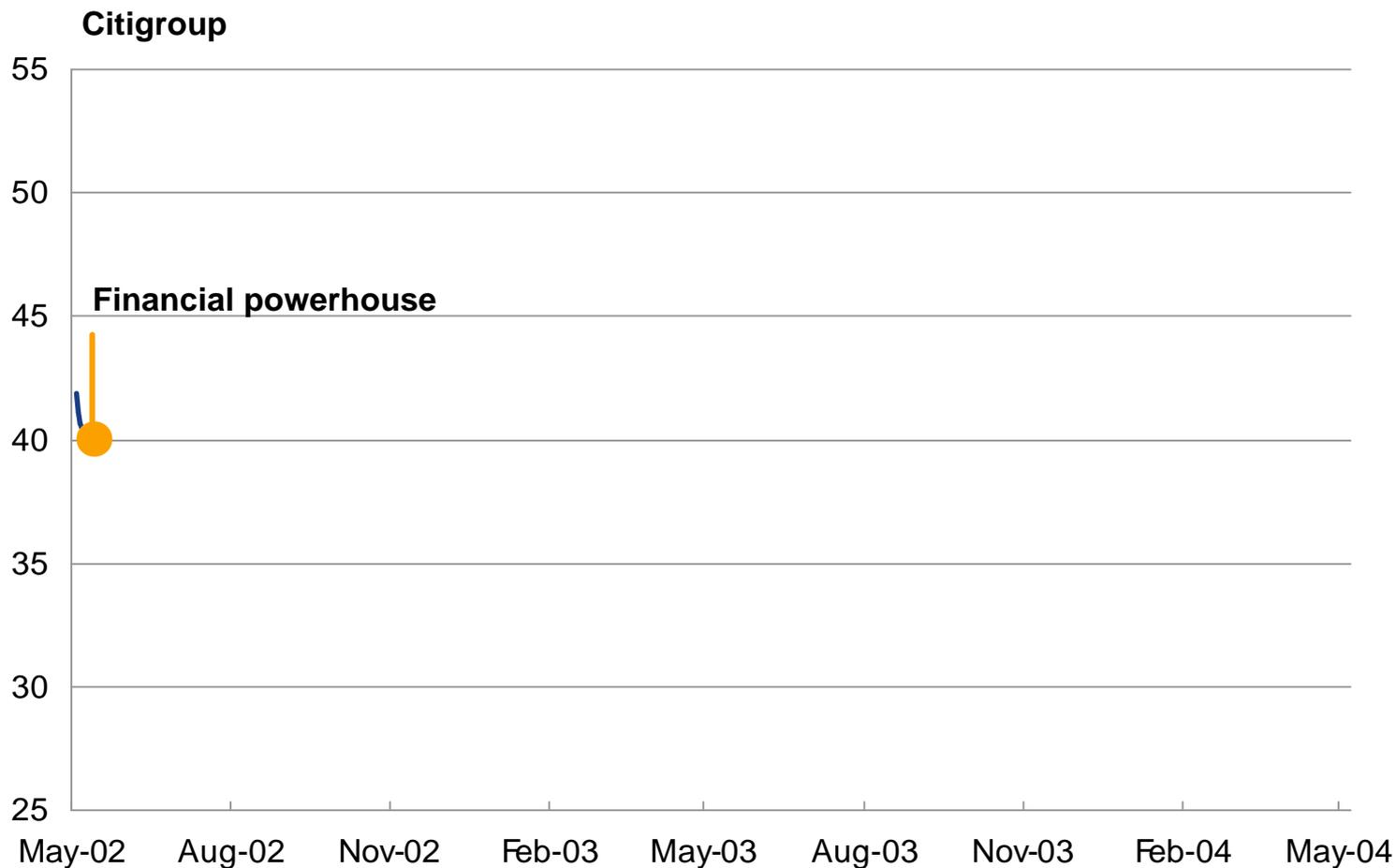
- ◆ Most of the short-term drivers of stock price are just noise
- ◆ Be opportunistic when the market overreacts

Oh, and use correct information

- ◆ Japan, Inc.
- ◆ Causes of death in US

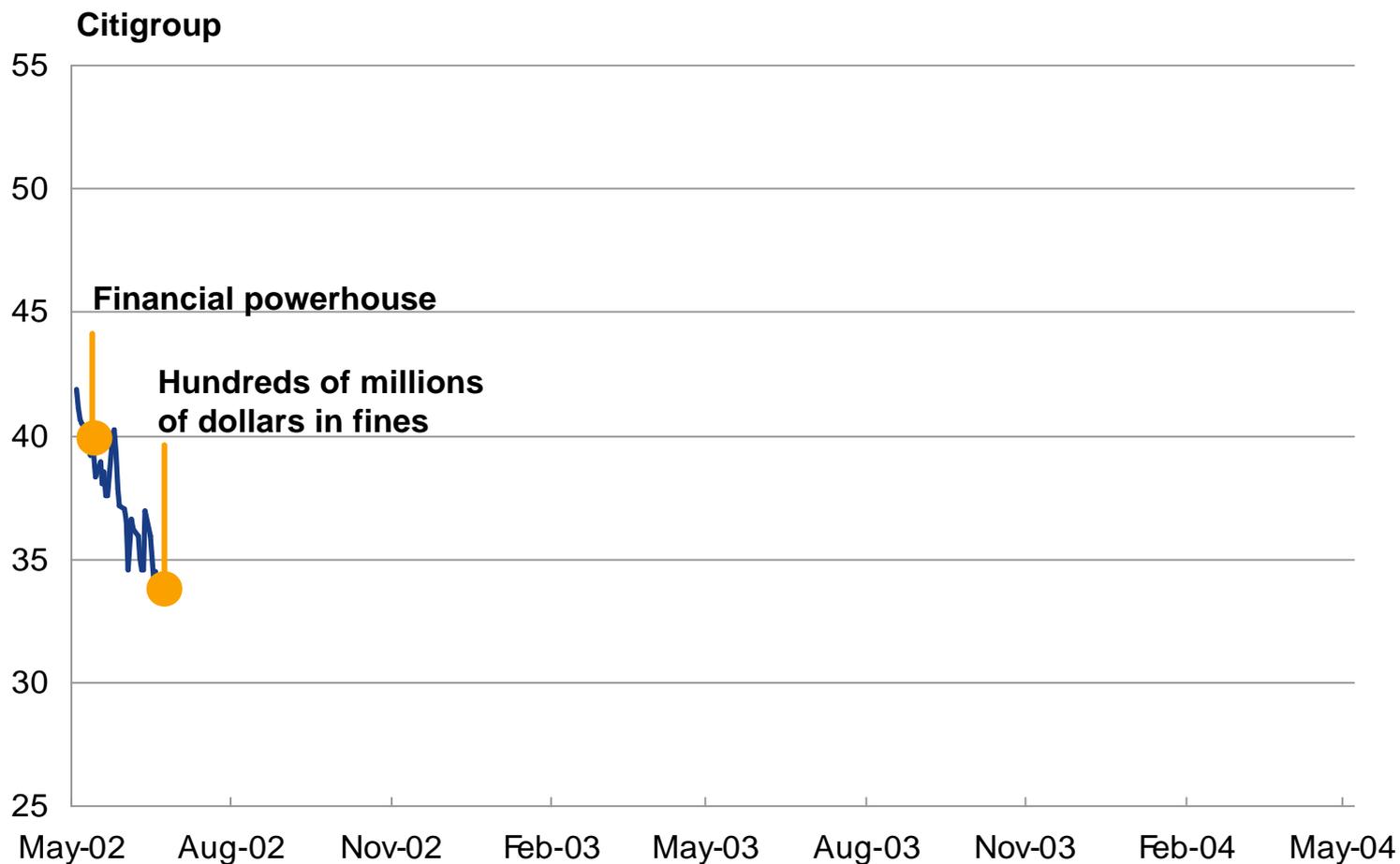
How to defeat your own behavioral tendencies

Too much emphasis on recent events



How to defeat your own behavioral tendencies

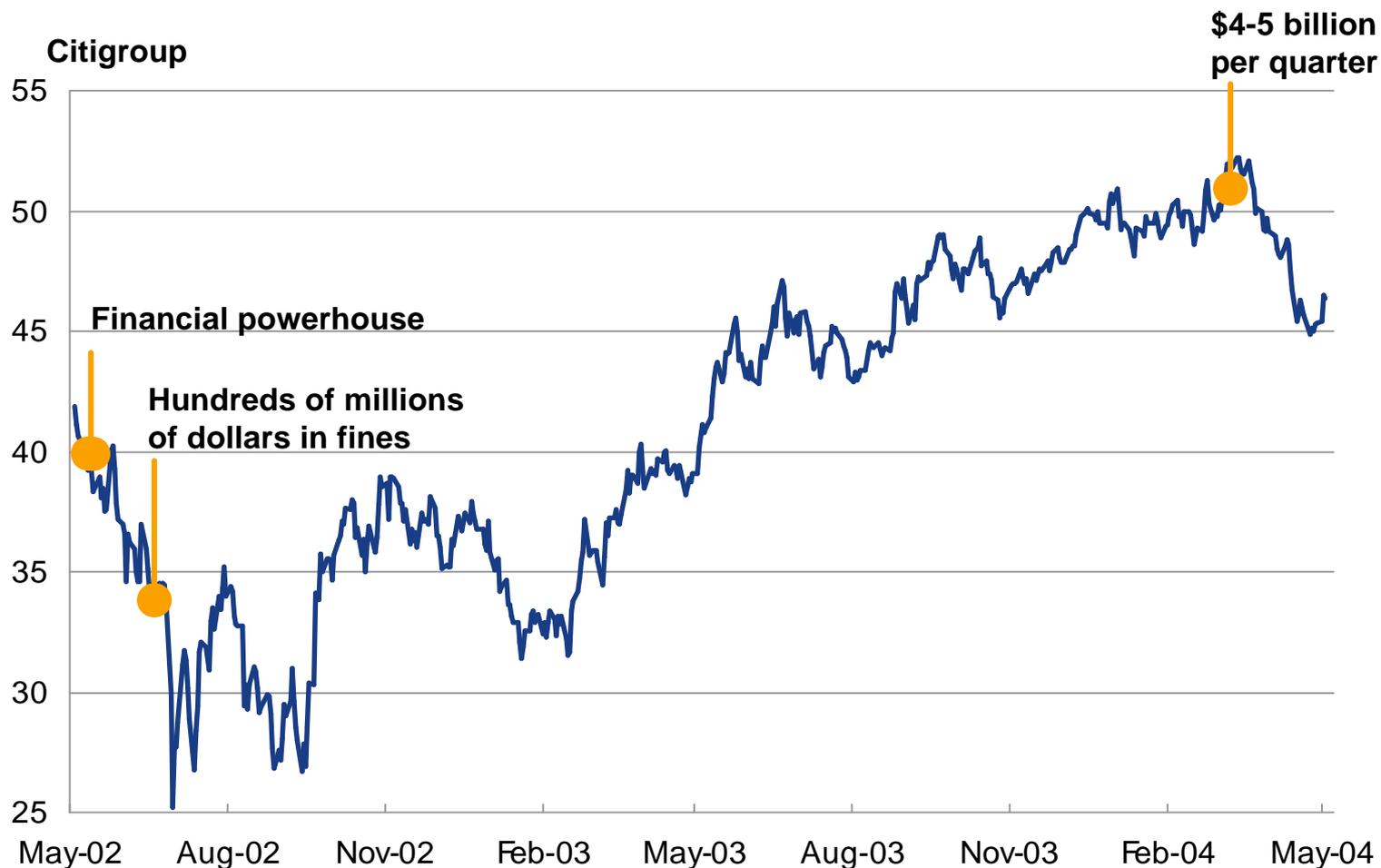
Too much emphasis on recent events



Source: Factset

How to defeat your own behavioral tendencies

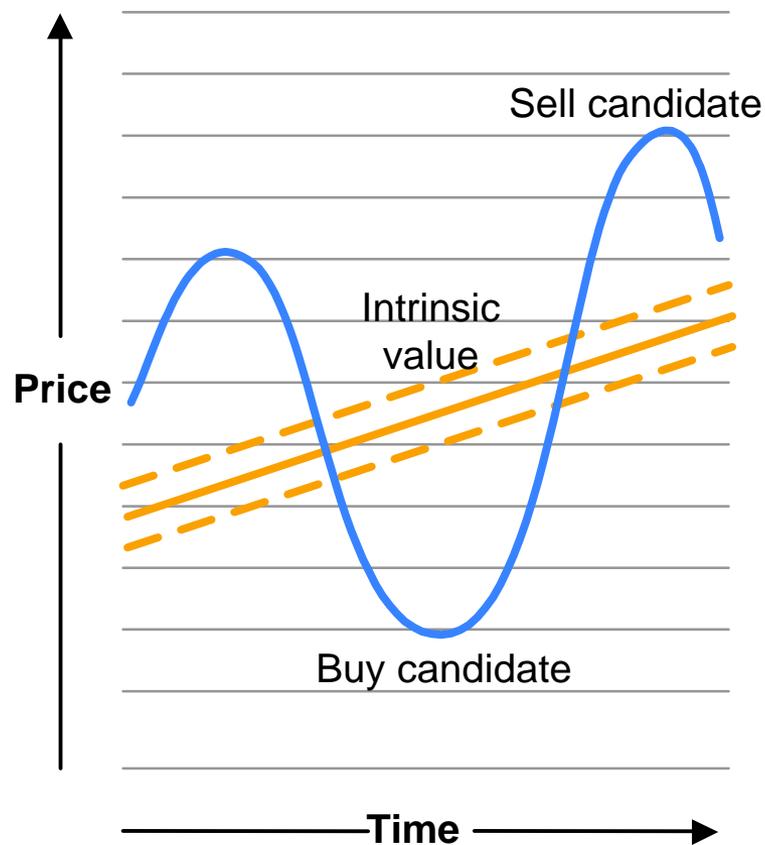
Too much emphasis on recent events



Overcoming behavioral bias

Stick with what you know

- ◆ Application of a consistent investment philosophy
- ◆ Focus on fundamentals
- ◆ Application of team skills and resources



Challenges for the successful investor

- ◆ Awareness of behavioral anomalies
- ◆ Recognize the short term noise
- ◆ Remain objective and consistent
- ◆ Do your homework

Answers from page 18: (1) 39 years; (2) 4,187 miles; (3) 13 countries; (4) 39 books; (5) 2,160 miles; (6) 390,000 pounds; (7) 1756; (8) 645 days; (9) 5,959 miles; (10) 36,198 feet.

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